No. 380

SUPREME COURT, U. S.

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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1958

COMMISSIONER OF
INTERNAL REVENUE ..... *Petitioner*

v.

BURL P. GLOVER ..... *Respondent*

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The findings of fact and memorandum opinion of the Tax Court are not officially reported.

The opinion of the Court of Appeals for the Eighth Circuit (G.R. 36-40) is reported at 253 F. 2d 735.

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BRIEF FOR THE RESPONDENT

QUESTION PRESENTED

The statement of the question in Petitioner's brief is improper in that it assumes the answer to the very issue before the Court. The phrase, "realizing part of their gain in cash and part in form of amounts credited to them", blithely presumes that taxpayer-dealer "realizes" gain when an entry is made on the books of the finance company.

Respondent submits that whether gain is realized is the issue to be decided here.

Respondent submits that the following represents a fair statement of the question:

Where an accrual basis taxpayer sells automobiles on a time payment basis, receiving part cash and a promissory

note for the deferred balance; and, where taxpayer sells said note to a finance company under the terms of a pre-existing contract providing for a stated discount or "reserve", and further providing that the portion of said reserve exceeding 3% of all unpaid balances of all notes sold to finance company would be paid to taxpayer; is the amount of the discount, or reserve, retained by the finance company (not in excess of 3% of note balances) taxable in the year the original reserve credit is made, or in the year in which taxpayer becomes entitled to withdraw or use it?

SUMMARY OF ARGUMENT

The taxpayer in this case is an automobile dealer reporting for income taxes on an accrual basis generally.

During all of the years involved, the taxpayer sold automobiles on a credit basis, and discounted, or sold, the notes receivable to C.I.T., under a pre-existing finance contract.

In reporting for tax purposes each year, the dealer excluded from income a portion of a reserve maintained on the books of the finance company, relying upon the finance contract. The excluded portion equalled 3% of the aggregate sum of all outstanding note balances purchased by the finance company from the taxpayer. So, the issue in the case is whether the 3% reserve so excluded should be taxed in the year in which the account entries are made.

The taxability of the total sales price at the time of sale to the customer is not in issue.

Under the express terms of the contract with the finance company, taxpayer had no rights to, or control of, the retained reserve during the taxable years involved. Taxpayer had no means at law to enforce any right to said reserve, or to have his rights declared. Even the amount of the retained reserve was subject to various contingencies which made computation of a fixed sum impossible.

The method consistently used by the taxpayer in deferring the inclusion of income from the retained reserve until he acquired the right to direct its use or withdraw it, properly, reflects his income, and is consistent with

many similar rules developed by the regulations and court decisions to meet specific business problems.

The Petitioner in brief urges reversal points to which respondent takes specific exception: namely,

That alleged administrative pronouncements have the effect of law;

That omission of gross income on the original sale is sought;

That taxpayer had constructive receipt of the retained reserve.

Whether the sale and financing are regarded as one transaction or two, the deferment of the 3% reserve under the terms of the finance contract until taxpayer acquires the right to direct its use, is a proper accounting treatment.

ARGUMENT

I

THE ISSUE IS THE INCLUSION IN INCOME OF THE PORTION OF THE DISCOUNT CHARGED BY THE FINANCE COMPANY TO WHICH TAXPAYER HAS NO PRESENT ENFORCEABLE RIGHT

Throughout his brief, Petitioner has referred again and again to the fact that at the time the customer signs the purchase agreement and note, the entire amount of the time sales price is accruable as income.

No one quarrels with such a statement, but it is not in issue in this case.

The taxpayer did not seek to exclude any part of the time price from income. The Commissioner, in his statutory notice, does not allege any such omission of income.

As stated in the statutory notice, the item in dispute is *a portion* of the discount, or "reserve", charged by the finance company upon sale of the customer's note to it.

The reserve withheld by the finance company is not identified with any part of the sales price, or the carrying charge, to the customer. The reserve is an amount reached by bargaining between finance company and dealer, governed by the terms of a written contract between them. The reserve amount in case of each sale is credited to an account on the books of the finance company. This account is a composite of all debts and credits to the reserve account, for whatever purposes, for all years, prior and current. Once the amount of the reserve on a single note is credited to the account, it loses its identity, and its ultimate payment, if ever, to the taxpayer-dealer depends on the terms of the Finance Company-Dealer Con-

tract, not upon payment or default by the particular customer.

It follows, therefore, that whether the taxpayer shall obtain a vested right to any portion of the retained reserve in any given year depends, under the contract, not upon payment or non-payment of customer notes discounted within the year, but upon the aggregate effect upon said account of the interplay of current credits and debits to the reserve and the *volume of all outstanding notes balances on which collections are being made by the finance company*, regardless of the year discounted.

The attempt by petitioner, in his brief, to twist the issue around to a question of the accruability of gross income at the moment of sale, is a distortion of his position as reflected by the statutory notice. He stated there (G.R. 10,12,14) that the entire amount credited to the reserve account during the year was taxable income. Taxpayer responded in his petition to the Tax Court of the United States (G.R. 3,4) by alleging that Respondent erred in including in taxable income the amount of the reserve account retained by the finance company under the contract.

Neither the reserve account credits, nor the retained reserve balance in each year, have any relationship to the gross income from the customer.

The retained reserve amounts to a reduction of gross income by virtue of a binding business contract between the finance company and the dealer—and the right of the taxpayer-dealer to the receipt, during the taxable year, of the 3% retained reserve, is the real issue in this case.

II

UNDER THE FINANCE CONTRACT, TAXPAYER HAD NEITHER POSSESSION OR CONTROL OF, NOR RIGHT TO, THE 3% RESERVE DURING THE TAXABLE YEAR

The agreement between the finance company and taxpayer (G.R. 23,24) provided that the finance company would purchase customer notes from taxpayer, and would withhold a reserve as set forth in the terms charts of the finance company. These terms were subject to variation from time to time, but the provisions setting up the right of taxpayer to receive the reserve remained fixed, and provided (G.R. 24):

> "Three times in each 12-month period, if we are not then indebted to you, *you will pay us our accumulated reserve in excess of 3% of the then aggregate unpaid balances on paper purchased from us.* If you stop buying our paper, you may hold and apply all reserves until liquidation of all paper purchased from us is completed" (emphasis added).

Under the express language quoted above, taxpayer had no claim to the 3% of unpaid note balance. His only claim was the right to *the excess* over said 3%. The finance company agreed only to pay the excess; taxpayer could not collect the 3%; he could not direct its application—in fact, he had no present right or interest in the 3% reserve withheld.

In this case, the taxpayer did not have an initial right to receive the reserve, which right he subsequently relinquished by agreement. Conversely, the contract was executed long before any amounts were credited to the dealers reserve, and taxpayer never at any time possessed any right to receive the 3% reserve.

> "Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis,

> import that it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes *fixed*, the right accrues." *Spring City Foundry Co.* v. *Commissioner*, 292 U.S. 182, 184, 185.

The question is not, "was C.I.T. financially able to pay the amount witheld?", as was apparently held pertinent in Brodsky, 27 T.C. No. 23, but "Did taxpayer have the right to receive it?"

Could taxpayer, at the end of 1949, have enforced a claim to the $3,885.71, representing 3% of the outstanding accounts?

The answer must be in the negative, since the contract specifically excludes the same from the obligation of the finance company to pay.

Could taxpayer *fix*, at the end of 1949, any definite amount to which he was or would become entitled? Again, the answer must be "no". The contract provides at least four specific obligations of taxpayer, unperformed at the end of the year, nonperformance of which would change the amount of the reserve withheld to which taxpayer might claim a right in the future; namely (G.R. 24,25):

(a) Obligation to purchase repossessed cars at amount equal to unpaid note.

(b) Obligation to share portion of refund of service charge, if any.

(c) Obligation under the full recourse liability in paragraph 7.

(d) Obligation to make good any deficiency incurred in resale of repossessed cars (par. 7).

As long as any of these obligations remained unperformed, the finance company could successfully resist any claim to the reserve.

There was no constructive receipt of the 3% reserve in the taxable year, because at no time did taxpayer have the right to demand payment. *North American Oil Consolidated* v. *Burnet*, 286 U.S. 417, 423.

> "Whether the plaintiff (taxpayer) would ever acquire a fixed right to receive anything from the reserve fund was contingent and unascertainable throughout the taxable year". *Keasbey & Mattison Co.* v. *U. S.* (3 Cir.), 141 F. 2d 163.
>
> "It is the fixation of the rights of the parties that is controlling." *Commissioner* v. *R. J. Darnell, Inc.*, 60 F. 2d 82, 84.
>
> "Realization of a (determinate) gain is the event which calls into pay the taxing act." *MacLaughlin* v. *Alliance Insurance Co.*, 286 U.S. 244, 249.

Whether or not the dealer actually receives anything from the finance institution, from the "retained reserve", depends upon the aggregate credits to the dealer on the financing institution's books, in excess of the agreed figure (in this case, three per cent of outstanding note balances). The "retained reserve" may never reach this figure. In the case of constantly increasing sales volume, a period of years might elapse before any vested right would become fixed.

The reserve account is a composite amount, representing all credits for prior and current years, less all debits for prior and current years. The Commissioner apparently argues as if the reserve account represents the finance charge on one transaction. Actually, the reserve retained by the finance company is not the same amount as the finance charge which the customer agrees

to pay. The reserve set up by the rate schedules of the finance company, may be more or less than the finance charge, depending upon the bargaining power of the taxpayer-dealer.

The petitioner in his brief seeks to liken the "retained reserve" on the books of the finance company to an account receivable, which it is claimed the dealer should report under the accrual method of accounting. That this argument is fallacious may be clearly demonstrated by a comparison of the legal rights of a creditor to an account receivable, as compared to the legal right of the dealer to the "retained reserve".

In the instance of the account receivable, the creditor has a fixed amount due on a fixed future date, or in installments on fixed future dates. In the event of a dispute over the amount owed or the date due, the creditor may proceed in federal court and in most state courts, under Declaratory Judgment proceedings, to have the amount due and the due date declared by court order. Furthermore, such an account is readily and customarily accepted as a basis for securing commercial loans by persons engaged in heavy sales on credit.

On the other hand, the "retained reserve" on the books of the finance company does not include *any* amount which the dealer has a right to demand, nor is there any ascertainable future date at which any definite amount will become vested in the dealer. Under these circumstances, and under the terms of the contract quoted above, no court could possibly find that the dealer had a fixed right to collect any amount at any future date. It is clear that no bank or other lending institution would lend to the dealer on such collateral. In fact, the finance company is the last resort in the commercial lending field for the automobile dealer, and the finance company refuses to

guarantee a single cent to the dealer from this "retained reserve".

The argument of the Commissioner that the accrual method of accounting requires the inclusion by the dealer of an indeterminate amount, which may or may not become due on some undetermined future date, and to which the dealer has no present enforceable claim or right, is not supported by any rule of business or tax accounting.

III

THE ACCRUAL SYSTEM OF BOOKKEEPING EMPLOYED BY TAXPAYER PROPERLY REFLECTS INCOME, AND IS CONSISTENT WITH RULES ALREADY APPROVED BY THE COMMISSIONER OF INTERNAL REVENUE AND THE COURTS

The accrual method of accounting requires that the taxpayer report as income all amounts which he has the right to receive during the taxable year. However, the principle is not to be applied arbitrarily, but is to be based upon practical consideration. As was stated by the Fourth Circuit in *Blaine Johnson* v. *Commissioner*, 233 F. 2d 952, 957:

> "Taxation is a practical matter; the substance of what is done and not the form must govern."

When one examines the substance of the transactions involved in this case, he finds that the sale of new automobiles has become a particularly specialized type of business. The facts of customer financing in this country require that the automobile dealer have a constant, ready means of providing major financing to the purchaser of a new automobile. Because of the high element of risk involved and the volume of financing required, practically all automobile dealers have turned to specialized finance institutions which operate almost exclusively in financing these operations.

The result is a three-cornered transaction involving a purchaser, the dealer, and the finance institution, all of whom are necessary contracting parties to the sale of the new automobile. Long before the customer enters into negotiations for the purchase, the dealer has executed a finance contract similar to the contract which is a part of the record in this case. The finance company furnishes printed forms to the dealer and these forms are used in closing the transaction with the customer. The transaction has been well described by the U. S. Court of Appeals, Fifth Circuit, in *Texas Trailercoach, Inc.* v. *Commissioner*, 251 F. 2d 395:

> "When we get down to what actually happened, at least in this case, we find one transaction—a three-cornered agreement with interrelated obligations of dealer, purchaser and finance company. Instead of being out of the first step of the transaction (the trailer sale to the purchaser), the finance company dictates the terms of the sale, has obligations running to it in the sales contract, has a fixed percentage for its finance charges worked into the sale price, and is as much a part of the substance of the business transaction as the dealer . . . (He (dealer) receives from the finance company 95% of the sales price plus a contingent claim, against the finance company, to the remaining 5%, then entirely under the dominion and control of the finance company. The dealer's claim to this 5% may never become fixed or ascertainable; it may never be received."

Furthermore, even if there are two transactions, in the first the taxpayer receives gross income, which is immediately reduced by the discount, the retained reserve, charged by the finance company.

In passing, it should be noted that the "retained reserve" provided in the contract between the dealer and the finance company is set up for the benefit and pro-

tection of the finance company, and is not an arrangement of mere convenience for the dealer, as was unfortunately held by the Board of Tax Appeals in *Shoemaker-Nash*, 41 B.T.A. 417. It certainly does not "protect" the dealer to have the finance company collect and use amounts which the dealer sorely needs in his own business. For example, if a buyer purchases realty, pays $1,000 down and agrees to pay the balance when and if title is found to be good, for whose protection is the reservation of payment? The answer is obvious, as in the instant case.

Under his method of accrual accounting, the taxpayer included all amounts which he had the right to receive during the taxable year, including the total sales prices to the customers, and excluded the "retained reserve" which he had no present right to receive. It is urged that this method properly reflects his income in each year and from year to year, and that it is consistent with the treatment presently used by other taxpayers with the approval of the Commissioner of Internal Revenue.

For example, in the identical transaction involved in the case, the finance company, as it receives the periodic payments from the purchaser, credits part of the payment to return of its principal and part to its income account. The finance company reports and pays income tax on the contract with the purchaser only as it receives the payments from the purchaser, since there is no "right to receive" any financial charges from the purchaser in the event that the purchaser prepays the contract or the automobile is repossessed. *Motor Securities Co., Inc.*, paragraph 52,136, P-H Memo Tax Court. To require the dealer to pay tax on an amount which he not only does not receive, but which the finance company refuses to promise to pay, is not in accord with any proper principles of accounting and would actually in practice lead to exhaustion of working capital of a new and growing auto-

mobile dealer. In the latter case, if the Commissioner's position were sustained, a dealer whose credit sales increased constantly over a period of years would not be entitled to recover any of the "retained reserve" under his contract with the finance company, but he would be required to pay income taxes at high rates; and the effect of this combination of circumstances would be to deplete the working capital of the business. This incongruous result is certainly not to be favored over the rational and equitable system of payment of income tax on the "retained reserve" in the year in which the dealer receives the right to collect it.

As a further example of existing regulations, recognizing the principle argued by the taxpayer in this case, we point out the Commissioner's long standing regulation with regard to "deferred-payment contracts". The present regulation is entitled "Reg. (T.D. 6314, file 9-17-58) 1.453-6, providing as follows:

> "Deferred-payment balance of real property not on installment method.
>
> (a) Value of obligations.
>
> (1) In transactions included in paragraph (b) (2) of Section 1.453-4, that is, sales of real property involving deferred payments in which the payments received during the year of the sale exceed 30% of the selling price, the obligations of the purchaser received by the vendor are to be considered as an amount realized to the extent of their fair market value in ascertaining the profit or loss from the transaction. . . .
>
> (2) If the obligations received by the vendor have no fair market value, the payments in cash or

> other property having a fair market value shall be applied against and reduced the basis of the property sold and, if in excess of such basis, shall be taxable to the extent of the excess. Gain or loss is realized when the obligations are disposed of or satisfied, the amount thereof being the difference between the reduced basis as provided in the preceding sentence and the amount realized therefor. . . .

Under this long-standing regulation, where obligations have no market value, or where the obligations received by the seller are contingent, the seller is not required to include in income the amount of the obligations until they have been received. Even if reporting generally on accrual basis. *C. W. Titus, Inc.*, 33 BTA 928; *Burnet* v. *S. & L. Bldg. Corp.*, 288 U.S. 406.

Certainly, it is not out of step with the principle of the foregoing regulation to postpone tax on items to which the taxpayer does not even have an enforceable right, and items which have no fair market value.

Another example of similiar treatment to that requested by the taxpayer in this case, is the handling of "patronage refund credits." Recently the Court of Appeals for the Fourth Circuit held that a taxpayer on the accrual basis did not receive income through the crediting of a patronage refund credit to his account on the books of a cooperative where such credit was subject to diminution because of various contingencies contained in the agreement between the taxpayer and the cooperative. *Long Poultry Farms* v. *Commissioner*, 249 F. 2d 726. The Internal Revenue Service has announced that it will follow the various decisions which culminated in the Long Poultry Farms case. The issue involved in the patronage

refund credit cases is so similar to the situation in the instant case that it would be difficult to reconcile the Commissioner's position in resisting deferment in the one case while acquiescing in the other.

In another similar situation, the Tax Court, in the case of commission accruals to an insurance company's General Agent's account, where books were kept on accrual basis, held that the agent was not taxable on such credits until the credits were subject to petitioner's unrestricted use and enjoyment. *Leedy-Clover Realty & Ins. Co.*, 13 TC 95, 106 (1949). In that case the agent's commissions were in existence and were placed in escrow pending the passage of time until the principal had been paid for each year and until the services required by the agent had been completed. In the instant case the "retained reserve" money is actually not even in existence, but is merely represented by book entries. Future events occurring after the end of the taxable year determine whether any amount will become payable under the contract.

Still another common example of the deferment treatment urged by the taxpayer is that allowed to building contractors, allowing deferment of taxation of the 10% retained reserve held under A.I.A. standard building contracts, *Comm.* v. *Cleveland-Trinidad Paving Co.*, 62 F. 2d 85, 86 (C.C.A. 6).

IV

SPURIOUS ARGUMENTS PRESENTED BY PETITIONER

A. *Reliance on Alleged Administrative Pronouncement*

The reliance by Petitioner upon action by Congress in making "two complete revisions of the Internal Revenue Code", without making any change in the law, Cf.

Cammarano v. *U. S.*, No. 29, this term, decided February 24, 1959, is completely misplaced.

At the time of the enactment of the Internal Revenue Code in 1954, Congres is presumed to have had knowledge of all Court decisions on the question. At the time of said enactment, the controlling decision by the appellate courts was *Keasbey & Mattison Co.* v. *U. S.*, 141 F. 2d 163. This decisions sustained the position taken by the taxpayer in the instant case.

If it can be said that Congress confirmed any position in 1954, (and this may be questioned in view of absence of any specific statute on the issue) it must be assumed that they adopted the decision of the Court of Appeals, Third Circuit, not administrative letters or inferior administrative rulings.

B. *Plea that Gross Income Accrued to Dealer when Customer Signed Sales Contract and Note*

In pressing the so-called "two-transaction hypothesis", petitioner first states that the time price included a finance charge, and that a portion of the finance charge was allocated to the dealer (Pet. Brief 41,42).

Nothing in the record supports this statement.

The finance charge to the customer is not the same thing as the reserve charged to the dealer by the finance company. The Contract between finance company and dealer sets up a legal relationship involving a reserve or discount (G.R. 24, par. 4). The Contract refers separately to "Service Charge" (G. R., par. 5), which is the finance charge to the customer—a different item, not directly related to the reserve.

Perhaps this error by petitioner led him into the mistaken assumption that, somehow, this case involves some definite portion of the total price charged the customer, which the dealer seeks to omit from income (Pet. Brief, 41,47,48,50). Such is not the case. As pointed out, *supra*, page 5 of this brief, the amounts in issue are amounts constituting 3% of all outstanding note balances of all customer notes sold to finance company by dealer at any time. In no sense does this 3% amount ($3,885.71 in 1949, $7,601.07 in 1950, and $7,952.41 in 1951) (G.R. 21) represent any ascertainable portion of the sales made to customers of dealer in the then current year.

In fact, the 3% reserve under the contract could fluctuate in exactly opposite direction to the volume of current sales by the dealer.

For instance, if customer's notes owned by finance company were paid off at a faster rate than sales volume increased, the 3% retained reserve excluded from income would decline, even in the face of increased sales.

Or, if in the current year, taxpayer-dealer started carrying his own paper to a large extent, while still selling a small amount of notes to the finance company, the 3% reserve would again decline, even though sales might be static or on the increase.

Respondent urges, therefore, that regardless of two-transaction or one-transaction hypotheses, the amount of the sales price to the customer is not in issue. Rather, the real issue is the retained reserve, and the dealer's rights under the contract with the finance company. Stated simply, the question is: Is the 3% reserve excludable from gross income until the year in which dealer is entitled to control or use of it?

c. *Argument That Taxpayer Has Constructive Receipt of Full Amount of Reserve (Discount)*

At pages 53, 54 and 55 of his brief, petitioner seeks to show that the full amount of the reserve credited by the finance company to the account maintained under the Contract was taxable immediately, without any adjustment for the 3% retained reserve.

In effect, petitioner argues that the conditions in the contract which determined taxpayer's right to withdraw the full reserve were only "conditions subsequent", and amounted to the satisfaction of obligations of taxpayer.

Petitioner thus ignores the paramount condition in the Finance Company-Dealer Contract—the condition that dealer has no right to any part of the reserve below 3% of outstanding note balances. This is not only a condition precedent to the right to receive anything, but a condition precedent to the right to have anything applied to any subsequent obligation of taxpayer which might arise under the other terms of the contract.

The Contract must control in any determination of taxpayer's right to income.

Petitioner's argument really reaches the question of the *amount* of the reserve account, and not the *right* of taxpayer to any amount, as at page 55 of Petitioner's brief, where this is said:

> "It is apparent, moreover, that in any event taxpayer ultimately would receive the full amount credited to the dealer's reserve account in cash or in discharge of his obligations to the finance company."

It may be seriously questioned whether the terms of the Contract regarding *amount* may, in fact, be conditions

precedent to taxpayer's right to the 3% reserve in issue. But, even if petitioner's claim that they are conditions subsequent is given full weight, this still leaves the complete bar of par. 4 of the Contract to the *right* of taxpayer to any claim upon the 3% retained reserve.

CONCLUSION

The judgment of the Court below in case No. 381 should be affirmed.

Respectfully submitted,

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